FAIR POLITICAL PRACTICES COMMISSION

Memorandum

To: Chairman Randolph and Commissioners Blair, Downey, Huguenin and Remy

From: C. Scott Tocher, Senior Commission Counsel
Luisa Menchaca, General Counsel

Re: *Hard/Soft Money*: Pre-notice Discussion of Proposed Regulation 18534 – Expenditures in Support of or Opposition to Candidates for State Elective Office, and Bank Accounts

Date: November 17, 2005

Executive Summary

Money laundering, a case where the true contributor of funds tries to remain anonymous, is among the most serious violations of the Political Reform Act ("Act").[1] In October of 2002, Woodland Hills-based 21st Century Insurance Group wrote checks ranging from $25,000 to $200,000 to the California Republican Party and GOP committees in 15 mostly rural counties. The checks were written the day after a deadline for disclosing receipt of such contributions. Some money was then shifted among committees and ultimately ended up in the accounts of legislative candidates in close races in the November 2002 election. It was reported widely that the committees gave money to candidates in districts outside their counties.

In June 2004, the Commission's Enforcement Division concluded an exhaustive and complex investigation into the events surrounding the November 2002 statewide election, culminating in the stipulations of three county central committees and their treasurers to violations of the law governing limits on contributions to candidates. The Commission assessed the maximum penalty ($10,000) against the San Joaquin, Butte and Kern county Republican central committees, and their respective treasurers. Each admitted two violations of Government Code section 85303 for accepting and making contributions to candidates for elective state office in excess of the applicable contribution limit.

As a result of the investigation, the Enforcement Division identified two important areas of the law that need regulatory action. First, the division recommends requiring committees to keep discreet accounts for contributions received that will be

---

[1] Government Code sections 81000 – 91014. Commission regulations appear at Title 2, sections 18109-18997, of the California Code of Regulations. All statutory references are to the Government Code, unless specified otherwise.

used for making contributions to candidates for elective state office ("candidate support account") versus contributions received that will be used for all other purposes, such as making independent expenditures, supporting local candidates or purely get-out-the-vote expenses ("non-candidate support account"). The purpose of this proposed requirement would be to ensure that the Franchise Tax Board (auditors), the Enforcement Division, the Commission, district attorneys and the public can be assured that money is not inadvertently or intentionally used in a manner contrary to the limit provisions of section 85303. Second, the Enforcement Division recommends the Commission adopt rules to ensure that once money is accepted by a committee for non-candidate support purposes, the money is not transfigured into candidate-support money by virtue of a subsequent transfer to another committee. In this way, a contributor cannot shield his or her identity by virtue of committees moving money around among each other. This memorandum briefs the Commission on the background animating the proposal and discusses the basis for and intent of each subdivision of the regulation.

I. BACKGROUND

A. Section 85303.

Section 85303, enacted when the voters adopted Proposition 34 in November of 2000, is part of the Act's chapter establishing contribution limits for candidates for state elective office. While other sections establish limits on contributions directly to candidates or to small contributor committees, section 85303 establishes limits on other recipient committees, and includes a special provision for political parties:

> **"§ 85303. Limits on Contributions to Committees and Political Parties.**
>
> "(a) A person may not make to any committee, other than a political party committee, and a committee other than a political party committee may not accept, any contribution totaling more than five thousand dollars ($5,000) per calendar year for the purpose of making contributions to candidates for elective state office.
>
> "(b) A person may not make to any political party committee, and a political party committee may not accept, any contribution totaling more than twenty-five thousand dollars ($25,000) per calendar year for the purpose of making contributions for the support or defeat of candidates for elective state office. Notwithstanding Section 85312, this limit applies to contributions made to a political party used for the purpose of making expenditures at the behest of a candidate for elective state office for communications to party members related to the candidate's candidacy for elective state office.
>
> "(c) Except as provided in Section 85310, nothing in this chapter shall limit a person's contributions to a committee or political party

committee provided the contributions are used for purposes other than making contributions to candidates for elective state office.

"(d) Nothing in this chapter limits a candidate for elected state office from transferring contributions received by the candidate in excess of any amount necessary to defray the candidate's expenses for election related activities or holding office to a political party committee, provided those transferred contributions are used for purposes consistent with paragraph (4) of subdivision (b) of Section 89519."

Thus, any contribution to a recipient committee (other than a candidate's controlled committee for elective office, a small contributor committee and a political party committee)[2] is limited to $5,000 if the contribution is for the purpose of making contributions to candidates for elective state office.[3] (§ 85303, subd. (a).) If made to a political party committee, the limit is $25,000 if the contribution is for the purpose of making contributions to candidates. (§ 85303, subd. (b).)[4] From these two subdivisions, one can deduce that contributions to these types of committees are unlimited *provided* the contributions received are *not* for the purpose of making contributions to candidates. In other words, contributions received for party-building activities, get-out-the-vote, independent expenditures, et cetera, are unlimited. As can be seen from the language of section 85303, then, whether a contribution is intended and used for a subsequent contribution to a candidate has a profound impact on whether the funds may be accepted and how they may be used.

B. 21st Century.

By design, Proposition 34 was intended by its legislative drafters to eliminate barriers for political party activities. (§ 1(a), Prop. 34, Findings and Declarations.) One of the most important means of achieving this goal is the way it allows parties to make unlimited contributions to candidates. While the money the parties accept may be limited when collected for purposes of making contributions, the limit is much higher than any other type of recipient committee.[5] Also, the parties can make an unlimited contribution

[2] These committees are addressed in different statutes or subsections: sections 85301, 85302 and 85303, subdivision (b), respectively.

[3] All references to "candidates" shall refer only to candidates for elective state office, unless otherwise indicated.

[4] The contribution limits of section 85303 are subject to periodic adjustment per section 83124 every two years to adjust for inflation. Effective January 1, 2005, the contribution limits for subdivisions (a) and (b) have been adjusted to the current limit of $5,600 and $27,900, respectively. (Reg. 18545.) For purposes of this memorandum, however, the original limits of the statute will be used to avoid confusion.

[5] "Political party committee" is defined as "…the state central committee or county central committee of an organization that meets the requirements for recognition as a political party pursuant to Section 5100 of the Elections Code." (§ 85205.)

to a candidate. Therefore, this scheme encourages large donations to be made to the parties who can in turn spend them on candidates.

This scheme is not objectionable provided it is not used to circumvent the contribution limits of the Act. However, the 21st Century case demonstrates how this scheme can unfold as the parties, elected officials and contributors become familiar with the provisions of Proposition 34.

As documented in the Commission stipulations (Exhibit 1), 21st Century Insurance Group spread roughly $1 million to 15 county Republican committees for use in competitive races in the closing days of the 2002 November state election. The contributions occurred after the last preelection report was filed by the parties, which concealed the contributions from disclosure until after the election. (The law has since been amended to provide disclosure within 24 hours of receipt by political party committees of such contributions.) Most of the central committees, in turn, made contributions to candidates who were not candidates in districts in their counties.

As a result of the investigation into whether any provisions of the Act were violated, the Enforcement Division concluded that it could prove that three central committees accepted and made contributions in violation of section 85303's limits. For instance, the Kern County Republican Central Committee and its Treasurer, Matt Brady ("respondents"), stipulated to the following: On October 22, 2002, the respondents accepted a $150,000 contribution from 21st Century and deposited the funds into the committee's candidate support account. The respondents admitted that by depositing these funds into the candidate support account they were demonstrated that they accepted the contribution with the intent of supporting or defeating candidates for elective state office, a violation of section 85303, subdivision (b) (a $25,000 limit). The respondents then made contributions a few days later to candidates running for office outside Kern County; specifically, Assembly Candidate Guy Houston ($30,984) and Senate Candidate Jeff Denham[6] ($44,855) for a total of nearly $76,000, in violation of section 85303, subdivision (c). The other stipulations describe virtually identical conduct and violations of the Act.

In the case of the Butte County Republican Central Committee, the parties stipulated to violations of the Act that included conduct not present in the other two. In the Butte County matter, the respondents (the central committee and its treasurer) used $10,000 of its $40,000 contribution received on October 22nd from 21st Century and gave it to the San Joaquin County Republican Central Committee the next day – which in turn contributed the funds to Assembly Candidate Guy Houston. There was no evidence the respondents notified San Joaquin that the funds were part of an over-the-limit contribution that could only be used for non-candidate support purposes. The respondents used the remaining funds that same day to make contributions totaling nearly $30,000 to other candidates for the Assembly, violating section 85303, subdivision (c).

[6] The stipulation mistakenly refers to Senate Candidate Jeff Denham as an Assembly candidate.

No allegations of misconduct ever were brought against either the state Republican Party or 21st Century Insurance Group by the Commission. Moreover, some cases investigated for violations similar to those described above were not brought due to a lack of evidence. This lack of evidence is attributed in large part to the insufficiency of bank account and record keeping requirements that are necessary to establish when money may have been used in contravention of the contribution limits. For instance, the Enforcement Division found in its investigation that most committees use only one bank account to make expenditures for both candidate support and non-candidate support. This made it extremely difficult in some instances to track whether the large contributions received from 21st Century were used for candidate or non-candidate support purposes.

As a result of the experiences that gave rise to the stipulations discussed above, the Enforcement Division recommends regulatory action be taken to address two issues: 1) the difficulty in enforcing contribution limits when over-the-limit contributions are commingled with non-candidate support funds; and 2) the use of successive transfers among committees to turn non-candidate support funds into candidate support contributions. Draft regulation 18534 attempts to reinforce the contribution limits on parties and committees by requiring dual bank accounts and prohibiting the transfer of non-candidate support funds to other committees for candidate support purposes.

II. REGULATION 18534

A. Construing Authority Under the Act.

Commission regulations are deemed valid so long as they are "consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute." (*Consumers Union of U.S. Inc. v. California Milk Producers Advisory Board* (1978) 82 Cal.App.3d 433, 447.) To interpret these terms, it is proper to look to extrinsic sources to determine the scope of section 85303 and the Act's contribution limit and reporting scheme. (*Estate of Griswold* (2001) 25 Cal.4th 904, 911; *Watson v. Fair Political Practices Commission, supra,* 217 Cal.App.3d, at p. 1076.) Extrinsic evidence includes voter pamphlet materials, legislative analysis and arguments of support for Proposition 34, and the express statutory purposes of the Act.

1. Proposition 34: Voter Intent.

When seeking to ascertain the voters' intent, the voter information pamphlet is an obvious source of information.

Proposition 34 was presented as a common-sense measure that "sets enforceable constitutional limits on campaign financing where none exist today." (Ballot Measure Summary, Cal. General Election, Nov. 2000, Prop. 34, Page 2.) The Legislative Analyst's summary of the initiative indicates throughout that the measure was intended to limit campaign fund transfers and contributions. (*Id.*, at p. 12-15.) Championing the

initiative as the voters' chance to "clamp a lid on campaign contributions," the initiative's supporters lamented:

> "Currently there are no limits on what politicians can collect and spend to get elected to state office. California is still the wild west when it comes to campaign fundraising. Six figure campaign contributions are routine. Proposition 34 finally sets enforceable limits and puts voters back in charge of California's political process.
>
> "PROPOSITION 34 LIMITS POLITICAL CONTRIBUTIONS. Proposition 34 brings strict contribution limits to every state office. These limits are tough enough to rein in special interests and reasonable enough to be upheld by the courts…." (*Id*., at p. 16.)

The importance of elections held under valid contribution limits was emphasized by supporters in rebuttal to ballot arguments made against the initiative:

> "PROPOSITION 34 WILL PUT THE BRAKES ON SPECIAL INTEREST DOLLARS. Special interests will be limited in what they can contribute to candidates.
> "…"
> Unlike other reform measures, Proposition 34 was drafted by experts to fully comply with all court rulings. It will allow candidates to spend enough to campaign effectively without allowing special interests to buy elections." (*Id*., at p. 17.)

2. Purposes of the Act.

To identify the purposes of section 85303 and other provisions, the Commission may also turn to the "ostensible objects to be achieved" by the Act. (*Estate of Griswold, supra.*) Section 81002 identifies the following relevant purposes for which the Act was enacted:

- "Receipts and expenditures in election campaigns should be fully and truthfully disclosed in order that the voters may be fully informed and improper practices may be inhibited.
- "Adequate enforcement mechanisms should be provided to public officials and private citizens in order that this title will be vigorously enforced." (§ 81002(a), and (f).)

The goal of the Commission and staff in interpreting section 85303 and other provisions is to construe the statute in a manner that is both consistent with its language *and* with the purposes of the Act. Any such construction would presumably be the correct one. (*Great Lakes Properties, Inc. v. City of El Segundo* (1977) 19 Cal.3d 152, 155.)

B. Proposed Regulation 18534.

Attached as Exhibit 2 is draft regulation 18534. The purpose of each subdivision is explained below in order of appearance. The essence of the regulation is this: Require committees who receive large contributions to establish separate accounts if they are to make contributions to candidates.[7] All deposits into the candidate-support account are subject to the applicable limit for that committee. When that committee then decides in turn to make contributions to candidates, it may do so *only* with funds deposited into its candidate-support account. Because funds over the limits will not be allowed into that separate account, the committee will not, intentionally or mistakenly, make contributions to candidates in excess of the applicable limits.

1. Subdivision (a): Definitions.

The first subdivision of the regulation defines the terms "non-candidate-support" and "candidate support" as used in the regulation. The definitions are gleaned from section 85303 itself, such that "candidate-support" refers to contributions made for the purpose of making contributions for the support or defeat of candidates for elective state office, which are subject to limitation under section 85303. "Non-candidate-support" refers to contributions received for all other purposes.

2. Subdivision (b): Establishing Separate Accounts.

As discussed above in the context of the 21st Century matter, the problem of tracking contributions to ensure the limits are not violated is a problem when a committee has received contributions *greater* than the limits applicable for candidate-support purposes and those funds are not segregated from the non-candidate funds. When contributions are made to support candidates from the mixed pool, it can be impossible at times to discern whether any of the over-the-limit funds were used to make the contribution. To remedy this accounting situation, this subdivision requires that small contributor committees and all committees governed by section 85303 that receive contributions greater than the applicable limit for that committee for candidate-support purposes ($200 for small contributor committees, $5,000 for non-party committees and $25,000 for political party committees) must, prior to making contributions to candidates, open a separate candidate-support account. To make clear the nature of the funds to recipients of any funds belonging to the committee as either candidate-support or non-candidate-support, the respective accounts must have such designation in its title. Two suggestions are given that would comply with the title requirements.

As a result, if a non-political party recipient committee receives only contributions under $5,000, it may make expenditures *both* for candidate- and non-candidate-support purposes *without* having to create a second account. This is consistent

[7] At the Interested Person's meeting held on this project in August, staff was informed by representatives of the state parties that this dual-account device is already used by many political party committees.

with the practical needs of small committees as relayed to staff during the Interested Person's Meeting held in August of this year. Under this scenario, since the committee never received a contribution that, if given in its entirety, could exceed the limit applicable to the committee for contributions to candidates, it does not matter if the committee has separate accounts. On the other hand, if a committee *does* receive a contribution over the limits, the separate accounts will ensure that only funds *up to* the applicable limit are deposited in the candidate-support account and only funds drawn from that account will go toward contributions to candidates, as set forth below.

3. Subdivision (c): Depositing contributions that are in excess of the applicable contribution limit:

Following on the steps taken in subdivision (b) that require a committee to open separate accounts if it wishes to accept contributions in excess of the limits for contributions to candidates, subdivision (c) requires the committee to deposit such contributions *first* into its non-candidate-support account. The committee then has 14 calendar days after receiving the contribution to transfer a portion of that contribution up to the applicable limit into the committee's candidate-support account. In doing this, the regulation harmonizes itself with the provisions of existing regulation 18531, which otherwise governs what committees must do when they receive contributions over the applicable limit. If the committee waits more than 14 days, it cannot transfer any of those funds over to the candidate-support account.

The authority for allowing use of an otherwise over-the-limit contribution is subdivision (c) of section 85303, which allows a committee to accept an over-the-limit contribution *if* the funds are used for non-candidate support purposes.

The purpose of the 14-day limit is to ensure that an excessive period of time does not elapse before the transfer of funds. The concern of the Enforcement Division is that the passage of time decreases the likelihood that the ascribed contributor of the funds is the true source of the transferred funds. Because there is no limit on the uses for which the funds in the candidate-support account can be used (the funds can be used for *both* candidate and non-candidate support), there is no reason to believe that it will not become standard practice for committees to transfer legal portions of large contributions into the candidate-support account. The 14-day period is thought sufficient to accomplish this transaction.

4. Subdivision (d): Earmarked contributions:

Earmarked contributions are contributions that a committee receives which the contributor directs to be used either for candidate- or non-candidate support purposes.[8] In the event the contribution is earmarked for either purpose and is under the applicable limit for that committee for candidate-support purposes, the committee shall follow the

[8] This is to be distinguished from earmarking a contribution for a specific candidate or ballot measure, in which case the committee receiving the funds is actually merely an intermediary for the contributor, in which case the original contributor is subject to the limits applicable to that person.

instructions of the contributor and deposit the contribution into the appropriate account. In the event, however, a contribution is earmarked for candidate support purposes and is in *excess* of the applicable limit for that committee, then the committee must return the contribution to the contributor within 14 days. This restates the rule contained in regulation 18531, governing the return of excessive contributions.

Taken together, subdivisions (c) and (d) work in the following manner: Unearmarked contributions *under* the limits can be deposited into either account according to the committee's wishes. A committee that receives an unearmarked contribution in *excess* of the limit is allowed to deposit the funds into its non-candidate account (the uses for which are not subject to limit) and may transfer an amount up to the applicable limit into its candidate-support account. If the contribution is earmarked, the committee must follow the instructions of the contributor, except where to do so would cause a violation of the applicable limit for that committee. In that event, the committee must return the contribution to the contributor.

5. Subdivision (e): The Rule.

This subdivision is a key component in the overall regulatory scheme. By ensuring that a committee may *only* make contributions to candidates from the committee's candidate support account, and because the deposits into that account are limited to the applicable contribution limit for that committee, the regulation ensures that only contributions of legal amounts will be used for purposes of making contributions to candidates.

6. Subdivision (f): Transfers among a committee's two accounts.

Conceivably, a committee could transfer funds back and forth between accounts, much like a family might transfer funds between various checking or savings accounts, as needed. The problem with such transfers in the context of political committees, however, is that the source and nature of the funds becomes harder to trace when the funds are moved back and forth. This is so because funds continue to come in and go out of the committee for all sorts of purposes, and determining what funds were used becomes problematic. Because section 85303 limits a person's contributions to committees if the contributions are to be used for making contributions to candidates, it is essential to keep track of that individual's funds to ensure that limit is not violated. As a result, the regulation forbids transfers from the non-candidate account into the candidate-support account except as allowed under subdivision (c) of the regulation.

Regarding transfers in the other direction, from the candidate-support account to the non-candidate support account, such a transfer is allowed. Such a transfer, however, does not create a new opportunity for a given contributor to make another contribution to the candidate-support account. This simplifies the accounting process – committees making such transfers will not need to try to attribute the funds transferred to any particular contributor, since the funds are going to its unlimited account where attribution would serve no purpose. It also reduces the temptation to engage in gamesmanship in

which contributors might be tapped inappropriately for additional contributions for candidate-support purposes.

7. Subdivision (g) – Prohibition against "cleansing" over-the-limit contributions:

Decision Point: One of the areas of abuse, both potential and real, is the practice of "cleansing" contributions that would otherwise be limited to non-candidate support purposes such that the funds are in fact used to make contributions to candidates – a violation of section 85303. As shown above in the 21st Century cases, this is accomplished by subsequent transfers among various committees, each committee taking excess money that cannot go for support of candidates and giving it to another committee that, in turn, uses the funds to make contributions.

In the political party context, it happens this way: Donor "D" makes a contribution of $75,000 to political party committee "A." Pursuant to section 85303, subdivision (b), A can only use $25,000 for the purpose of making contributions to support or oppose a candidate. So, the committee takes $25,000, puts that into its candidate-support account, and then puts the remaining $50,000 into its non-candidate-support account. Then, the committee takes the $50,000 and splits it, giving $25,000 to political party committees "B" and "C." B and C deposit their respective $25,000 checks into their candidate-support account and make contributions to support or oppose candidates. In this way, the parties have taken the $75,000 original contribution, of which only $25,000 could be used for contributions, and has converted the other $50,000 into contributions to candidates. This has two negative impacts. First, the limit of section 85303, subdivision (b), is violated. Second, the true contributor of the funds, D, is concealed. While it is true that A has to report it received funds from D in its filings, only A is identified as the source of contributions to both B and C. If A is a large committee receiving multiple contributions, the public may not know that the funds actually came from D. Clearly, such a result is inconsistent with the purposes of the Act's contribution and disclosure laws.

Therefore, subdivision (g) provides the rule that a committee may not transfer or contribute funds from its non-candidate-support account into another committee's candidate-support account. To ensure both contributor and recipient are aware of the nature of the funds being contributed, the contributing committee must notify the recipient committee from which account the funds are drawn. The regulation establishes a presumption that if the check indicates from which account the funds are drawn, such will be adequate notice.

Staff recommends the Commission include subdivision (g) in the OAL-noticed version of the regulation 18534.

Attachments:
Exhibit 1: Stipulations
Exhibit 2: Draft Regulation 18534